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FEDERAL COMMUNICATIONS COMMISSION
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Before the
**FEDERAL COMMUNICATIONS COMMISSION**
Washington, D.C. 20554

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| In the Matter of | ) | |
| | ) | |
| Price Cap Performance Review for Local Exchange Carriers | ) | CC Docket No. 94-1 |
| | ) | |
| Treatment of Operator Services Under Price Cap Regulation | ) | CC Docket No. 93-124 |
| | ) | |
| Revisions to Price Caps Rules for AT&T | ) | CC Docket No. 93-197 |

**COMMENTS OF THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES**

Richard J. Metzger
General Counsel
**Association for Local Telecommunications Services**
1200 19th Street, N.W., Suite 560
Washington, D.C. 20036
(202) 466-3046

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## SUMMARY

The Second NPRM poses a critical issue for the Commission at this stage of its efforts to advance competition while also reforming regulation (at ¶ 2):

> "We propose that generally these rule revisions be effective for all price cap LECs without regard to the current level of competition because they will serve our goals of moving prices toward costs, encouraging efficient investment in infrastructure, and ultimately producing robust competition. An alternative approach would be to require LECs to satisfy an objective set of criteria established by the Commission indicating the presence of a certain measure of competition for a particular service or services within a prescribed geographic market before certain of the proposals would be effective." (Emphasis supplied.)

With all due respect, the Second NPRM's proposal to lift pricing regulation before the emergence of competition lacks any economic or institutional foundation. It should be absolutely clear to the Commission that the "alternative" approach of linking regulatory changes with improvements in the competitive environment is, in fact, the only meaningful choice for two compelling reasons.

First, it is painfully but unmistakably clear the Commission has no effective power to require the incumbent local exchange carriers ("LECs") to take pro-competitive steps until such time as they choose to do so. It is now almost nine years since the Commission was originally asked to order expanded interconnection

-- which is only one of the several regulatory changes needed to create robust local competition -- yet most expanded interconnection tariffs remain under investigation! The grim institutional truth is that the LECs will duck and dodge their pro-competitive obligations until it is convenient for them to comply unless their own deregulatory agenda is also at stake.

Second, the Second NPRM's belief that prices will altruistically gravitate to economically efficient levels in the absence of competition is patently incorrect, as evidenced by the huge amount of downward pricing flexibility the LECs have yet to use. Adam Smith's "invisible hand" simply doesn't apply to monopoly providers which enjoy high barriers to entry.

Equally dismaying as a conceptual matter is the Second NPRM's new-found desire to benefit access consumers "by encouraging only efficient competitive entry" (at ¶ 6). This is pure "voodoo economics." From a consumer welfare perspective -- which is the only view the Second NPRM claims to represent -- it is axiomatic that consumers benefit from all kinds of competitive entry, be that entry efficient, inefficient, smart, ignorant, or whatever. Customers can never be injured by an increase in their market choices: they always benefit no matter how much of a loss is suffered by investors in competitive entities or in the LECs.

Furthermore, while the detailed questions in the Second NPRM concerning the possible linkages between reduced price cap regulation and removal of barriers by the LECs are thoughtful, they are unduly limited to price cap changes, and fail to incorporate the Commission's upcoming access reform docket and its new pro-competitive dockets that will be starting in January.[1] Rather than try to select preconditions for specific price cap changes in a vacuum, the Commission instead should:

- Decide to link all substantial regulatory changes (including access reforms) to "checklists" which would link the LECs' progress on removing barriers to competition to the timing of such regulatory changes; and,

- Solicit comments concerning the specific factors that should exist in various "checklists" pertaining to price cap reform, access charge changes, universal service reform, etc., much like the "interLATA checklist" contained in proposed Federal legislation. Once the basic outlines of each "checklist" has been defined, their particulars can be addressed in specific proceedings.

As the Second NPRM acknowledges, the overall checklist approach has been adopted by both Houses of Congress, and in the Department of Justice's proposed interLATA experiment. The concept should be extended to both price cap and access reform, and immediately put out for expedited comments so that it can be effectively applied in the Commission's pro-competitive dockets.

[1] See the speech of Chairman Hundt delivered December 5, 1995, indicating that rulemakings on access reform and various pro-competition dockets, such as interconnection, will commence in January.

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**COMMENTS OF THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES**

Pursuant to the Second Further Notice of Public Rulemaking ("Second NPRM") released September 20, 1995, in the above proceeding, the Association for Local Telecommunications Services ("ALTS") hereby comments on the Second NPRM's proposal to "establish a framework for three gradations of increasingly less stringent price regulation" (id. at ¶ 2).

## I. ALTS' INTEREST IN THIS PROCEEDING

ALTS is the non-profit national trade organization representing competitive providers of local telecommunications services. ALTS' membership include over thirty non-dominant providers of competitive access and local exchange services which deploy innovative technologies in many metropolitan and suburban areas across the country. ALTS, as well as several of its individual members, participated actively in the Commission proceedings which gave rise to expanded interconnection (Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141; "Expanded Interconnection").

ALTS' members would be affected by the Second NPRM's desire to prevent "inefficient entry," and its apparent belief that LEC access prices would move to efficient levels once pricing restrictions are lifted even in the absence of competition.

## II. THE COMMISSION IS UNABLE TO CONTROL THE LECS' EFFORTS TO REMOVE BARRIERS TO COMPETITION UNLESS THESE ARE LINKED TO THE REMOVAL OF LEC REGULATION.

The Second NPRM proposes "that the changes we describe herein generally be effective without regard to the current level of competition" (at ¶ 34), but it also discusses an "alternative" of linking its three-part approach to decreasing levels of price cap regulation with the LECs' pro-competitive efforts (¶ 106):

> "In this section, we propose to examine the existence of competitive circumstances within a given geographic and product market in terms of barriers to competitive entry in the market. We tentatively conclude that lowering entry bariers is the most appropriate mechanism for conditioning

> <u>additional price cap flexibilities because additional flexibiliites within the price cap framework are forms of regulatory relief that are intended to allow the LECs to respond to emerging competition</u> ..." (Emphasis supplied.)

In the course of explaining, quite correctly, why the removal of barriers to competitive entry which the LECs have some control over is the most appropriate pre-condition for regulatory relief, the <u>Second NPRM</u> has also stumbled upon the reason why this linkage is so essential (<u>id</u>.): " ... Flexibilities within the price cap framework are <u>forms of regulatory relief</u> that are intended to allow the LECs to respond to emerging competition ..." (emphasis supplied). Linkage is critical because it makes no sense to allow the LECs to <u>respond</u> to competition in <u>advance</u> of that competition taking place!

Indeed, the <u>Second NPRM</u> never confronts its implicit assumption that the Commission will be able to issue price cap relief to the LECs in the present docket, access reform in subsequent dockets, and somehow manage to make satisfactory progress towards advancing competition in <u>Expanded Interconnection</u>, number portability, and other proceedings which will be devoted to pro-competitive initiatives. This assumption is absolutely mistaken.

A short history of the expanded interconnection docket provides a convincing demonstration of the LECs' virtually unfettered ability to delay any pro-competitive obligation they find inconvenient. The Commission was first petitioned to provide expanded interconnection almost nine years ago,[2] yet most LEC expanded interconnection tariffs are still under investigation. Several LECs use the ambiguities of the tariffs and the technological details of expanded interconnection to slow-roll interconnectors and inflate prices, as is well explained in the recent Phase II responses of MFS and Time Warner filed November 9, 1995. Other LECs, such as Ameritech, have assumed the mantle of pro-competitive champion through such tactics as offering physical collocation as part of its original "Customers First" proposal, then dropping the offering as soon as it obtained a legal excuse.[3]

However, some LECs don't even feel the need to be subtle about throwing roadblocks at competition in the expanded interconnection docket. In its order creating virtual collocation, the Commission noted that the LECs had an incentive

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[2] See TCG's petition for a declaratory ruling filed I March 27, 1987.

[3] Compare Ameritech's description of its "Advanced Universal Access Plan," in which it proposed to offer: "Physical collocation using switched access-type connection between the AEC [alternative exchange carrier]-provided facility and Ameritech's trunk circuit;" (Final Report of ARRC Staff Concerning Ameritech Petition dated April 1, 1994, at 18), with the July 7, 1994, ex parte of Ameritech following the D.C. Circuit's remand of the Commission's physical collocation order: "[Ameritech] will honor its existing tariffs until they have been modified or withdrawn, but as a policy matter will not offer physical collocation."

to inflate the equipment costs borne by their interconnector-competitors. Expanded Interconnection with Local Telephone Company Facilities, CC Docket 94-1, Order released July 25, 1994, at ¶ 124. Accordingly, the Commission took note of the long-standing doctrine that the costs charged by a common carrier should be prudently incurred, and indicated it would look to offers of equipment made by interconnector-competitors to the LECs in the course of judging the reasonableness of the LECs' rate components for equipment. Since there is no difference to the LEC if a piece of equipment that a arrives at a central office loading dock comes from from an interconnector-competitor instead of a vendor, except for its price, it seemed clear the LECs would be willing to accept low-cost equipment offers from interconnectors.

Unfortunately two large LECs, US West and SWB, felt quite immune to this logic, and filed tariffs on September 1, 1994, in which they refused to accept offers of equipment from interconnectors.[4] After this anti-competitive defiance was

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[4] See, e.g., SWB's outrageous preconditions (D&J at 4-5):

"SWBT will consider such offered prices [by interconnectors] to be reasonably set if the interconnector offers the price under the same terms and conditions it offers such equipment to any other purchaser of the equipment and, if the interconnector holds itself out as the least-cost provider, SWBT must be allowed to purchase as many units of the equipment as it desires, even if such equipment will be used by SWBT to provide service to others."

brought to the attention of the Commission, each carrier changed its stance. Incredibly enough, however, they now claim their earlier behavior should not be investigated and acted upon by the Commission because so few interconnectors took service. In short, they point to their anti-competitive success as a procedural defense![5]

This sad history is relevant to the present proceeding because it reveals the naivete of the Second NPRM's belief that the LECs can be granted price cap freedom, and, ultimately, access reform, and still somehow be required in separate dockets to carry out expanded interconnection, number portability, unbundled loops, etc., in any timely fashion. The opportunities for obfuscation and delay that are created by tariff and technical complexities, combined with the Commission's virtually impotent administrative remedies, are just too rich with opportunities for delaying tactics. Once the LECs are free from price cap and access charge regulation, the Commission might as well shut down its regulation of LEC wireline activities for all the good any continued pro-competitive jawboning would do.

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US West was even more blunt (D&J at 2-4): "US West does not intend to purchase equipment quotes from interconnectors, regardless of the price proffered from them to us." (Emphasis supplied.)

[5] US West Direct Case in Phase II filed October 19, 1995, at 5, n. 10.

## III. THE SECOND NPRM'S PROPOSAL TO GRANT DOWNWARD PRICING FLEXIBILITY IN THE ABSENCE OF COMPETITION IS UTTERLY LACKING IN ANY ECONOMIC RATIONALE.

The Second NPRM devotes little discussion to its assumption that removal of downward pricing restrictions will lead to economically efficient pricing even in the absence of competition, or to its conclusion that prevention of certain forms of entry will somehow benefit consumers. See, e.g.:

> "We propose that generally these rule revisions be effective for all price cap LECs without regard to the current level of competition because they will serve our goals of moving prices towards costs, encouraging efficient investment in infrastructure, and ultimately producing robust competition." Id. at ¶ 2.
>
> "Allowing greater downward pricing flexibility will benefit consumers both directly through lower prices and indirectly by encouraging only efficient competitive entry." Id. at ¶ 6.
>
> "A goal of our policies is to promote economic efficiency, which includes regulating prices so that they emulate the economic proformance of competitive markets as closely as possible until actual competition arrives." Id. at ¶ 18.
>
> "Services above costs also attract inefficient service providers. Prices establish important decision-making signals for both potential (and existing) suppliers of communications services as they do for users of these services. If the prices that LECs are permitted to charge are held above the competitive level by our regulation, inefficient entry may be encouraged. Furthermore, such entry may occur in the expectation that existing price relationships will be maintained. Permitting rates to reflect costs will limit new entry to efficient providers." Id. at ¶ 25.

As shown below, the economic "reasoning" in these passages is internally inconsistent, and contradicted by evidence and existing economic theory.

### A. **There Is No Such Thing as an Altruistic Movement <u>to Efficient Price Levels by a Monopolist</u>.**

One troubling pattern in the <u>Second NPRM</u> is the fashion in which its most grevious errors are simply assumed into existence without explanation, as in its definition of "competitive harm" (<u>id</u>. at ¶ 28):

> "... We define competitive harm in terms of the ability of a LEC to prevent prices paid by access customers from moving toward their efficient economic cost ..."

But this definition contains the startling assumption that monopoly prices will move to efficient levels unless they are somehow "prevented." There is no precedent in any economic literature for making such an assumption about the prices set by a monopolist in a market which has substantial barriers to market entry.

True, ever since the time of Adam Smith it has been assumed that the prices set in a truely competitive market would reflect an "invisible hand" that results in efficient pricing levels. But as for monopoly markets -- such as an LEC's access prices in the absence of competition -- it has always been assumed the monopolist would price either at profit maximizing levels, or at levels which would best deter competition while having the least effect on its total corporate worth. Indeed, this is the underlying justification for the Sherman Act, the Clayton Act, the Federal Trade Commission, etc. The Second NPRM's assumption of altruistic monopoly pricing is simply unknown to academic literature.

It is also no doubt true that many LECs would reduce access prices by some amount, if given the chance, but this is hardly proof that the resulting levels are socially efficient prices, or close enough thereto to have a meaningful improvement in overall economic welfare. First, as shown in the accompanying statement of Mr. W. P. Montgomery, the LECs already possess considerable price reduction flexibility which they have not employed. Such unused freedom plainly contradicts the Second NPRM's assumptions about altruistic pricing.

Second, and perhaps even more importantly, there is no sound basis for concluding that any reduction in access prices would produce at least some benefit at the margin so long as it moves prices closer to economic costs. As Mr. Montgomery's statement explains, the large incentives that exist for predatory pricing stongly suggests that the increased risk of anti-competitive pricing by the LECs would far outweigh any speculative improvement in overall pricing optimality from LEC access price reductions in the absence of competition.

The Second NPRM fails to recognize that competition in the access market simply cannot be analyzed in a vacuum because the normal competitive entry path into local exchange markets starts with entry into access markets. This means that the LECs have much more at stake in setting access prices than just their access revenues, and that their strategic goals extend far beyond the limited recoupment of potential predatory pricing gains to which the Second NPRM's analysis is limited.

## B. Consumers Benefit from Any Kind of Competitive Entry.

The Second NPRM's concern about about benefiting consumers "indirectly by encouraging only efficient entry" (id. at ¶ 6), is also profoundly puzzling. Assuming for the sake of argument that the Commision really has the ability to lure competitive companies into "inefficient entry" (an assumption which ALTS vehemently disputes for the reasons set forth infra), how could prevention of that entry ever benefit an access consumer? No doubt some gas station owners have could come to regret having moved to a street corner across from a gas station that already exists. But no motorist has even regretted such an event, or been hurt by any resulting price competition.

It may well be that the investors in a competitive entity, or in the LEC it chooses to compete with, might well be harmed as a result of an imprudent decision to enter a market. But the

Second NPRM does not claim to be protecting competitive investors or LECs from unwise decisions. Instead, it speaks only in terms of consumer welfare, and it is manifest that consumers always benefit from competitive entry, no matter how imprudent any particular entry proves to be.

Beyond the Second NPRM's confusion of investor welfare with consumer welfare, it is also mistaken in its belief the Commission could somehow "lure" competitors into "inefficient" entry. Based on this belief, it concludes the Commission could save potential competitors from such an error by abandoning its downward pricing rules. Again, there is no theoretical basis for such a belief, and it is contradicted by the Commission's many pronouncements concerning its goal of moving all prices to a cost basis as soon as possible.

Robert Lucas won the Nobel Prize in Economics this year for his work over twenty years ago demonstrating that the economic consequences of public policy cannot be kept "secret" from rational private parties which possess adequate incentives to discover the truth. While Lucas' work was directed at the Keynesian theory of economic macromanagement through governmental fiscal policy, it is just as true concerning the Commision's regulation of access rates. Given the Commision's consistent commitment to competition in preference to monopoly provisioning, the Commission could not have successfully concealed the fact that access charges would eventually be deregulated (and thereby dupe some competitive providers to engage in "inefficient entry" based on regulated rates), even if it had attempted to deceive the competitive industry concerning its intentions.

Of course, no such campaign of "regulatory disinformation" concerning access has ever been undertaken by the Commission. Whether in the "equal unit of traffic" waiver, or in earlier orders in this very docket, the Commission has always and repeatedly emphasized its desire to move access charges to costs.[6] The Second NPRM's concern for "inefficient entry" is thus a regulatory bogeyman which deserves no attention whatever from the Commission.

## IV. THE COMMISSION NEEDS TO IMMEDIATELY ADOPT A CHECKLIST APPROACH WHICH LINKS ALL REGULATORY REFORMS SOUGHT BY LECS WITH BARRIER REMOVAL.

The core virtue of the Second NPRM is its recognition of a potential "carrot and stick" approach which would link LEC regulatory freedom to LEC success in removing entry barriers:

> "Properly designed, our system of price regulation should facilitate the transition to competition in local and interstate telecommunications markets by offering incentives for incumbents to foster competitive markets for particular services." Id. at ¶ 7.
>
> "We could predicate the granting of relaxed regulatory

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[6] See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786 (1990) at ¶ 198.

> treatment or additional pricing flexibility on a demonstration that certain barriers to competitive entry into the local services market have been removed. Basing relaxed regulatory treatment and additional pricing flexibility on the elimination of entry barriers can serve as a mechanism for encouraging LECs to open their markets to local competition." Id. at ¶ 107.

The Second NPRM goes on to solicit specific comments about the contents of a potential checklist, relevant market and service definitions, and particular barrier removal "triggers" that would apply to different levels of price cap freedom (id. at ¶ 108).

The Second NPRM's discussion of a potential checklist approach is quite thoughtful and fully deserves credit for recognizing how both Houses of Congress and the Department of Justice have employed a checklist approach which is linked to Regional Bell Operating Company ("RBOC") entry into interLATA service. However, the Second NPRM is premature in seeking specific comments as to a "price cap" checklist when the Commission has not yet adopted the basic concept, nor considered whether it should also be applied in the upcoming access reform docket or in the pro-competitive proceedings referenced in Chairman Hundt's speech of December 5, 1995.

The better approach would be for the Commission to first adopt the checklist concept, decide on how many checklists are necessary and their basic components, and then to solicit comments about specific linkages in the relevant individual proceedings. Too much speculation is required at the present time to comment meaningfully on a "price cap" checklist without also knowing the basic contours of the Commission's proposed access reform, universal service reform, interconnection proposals, etc.

## CONCLUSION

For the foregoing reasons, ALTS requests that the Commission:

- Decide to link all substantial regulatory changes (including access reforms) to "checklists" which would link the LECs' progress on removing barriers to competition to the timing of such regulatory changes; and,
- Solicit comments concerning the specific factors that should exist in various "checklists" pertaining to price cap reform, access charge changes, universal service reform, etc., much like the "interLATA checklist" contained in proposed Federal legislation. Once the basic outlines of each "checklist" has been defined, their particulars can be addressed in specific proceedings.

Respectfully submitted,

By: Richard J. Metzger

Richard J. Metzger
General Counsel
**Association for Local Telecommunications Services**
1200 19th Street, N.W., Suite 560
Washington, D.C. 20036
(202) 466-3046

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**Pre-Competitive Pricing Flexibility for Price Cap LECs**

William Page Montgomery

## Introduction

In a recent Notice,[1] the Federal Communications Commission requested comments on a variety of mechanisms by which local exchange carriers (LECs) subject to the Commission's price cap rules could enjoy greater flexibility in setting prices for regulated services. The Commission described three levels of potential LEC pricing flexibility. The latter two of these levels would require increasingly strong demonstrations that the LEC services are subject to actual competition, but the first level would be implemented without regard to competition. This first level of added pricing flexibility would grant the LECs unlimited downward pricing flexibility and could include changes in the composition of the current four price cap baskets.

The Notice indicates that the Commission is disposed to grant price cap LECs additional downward pricing flexibility, if doing so would not harm competition or consumers while eliminating unnecessary regulation. The Notice defines "competitive harm" to include any of three outcomes: Preventing access prices from moving towards efficient economic costs, reducing the quality or range of services offered by price cap LECs, or imposing unreasonable endogenous barriers to entry.[2] An endogenous barrier to entry is one which is under at least the partial control of the dominant incumbent supplier of services — in this case, the price cap LECs.

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[1] Price Cap Performance Review for Local Exchange Carriers, Second Further Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 95-393, September 20, 1995 ("Pricing Flexibility Notice").

[2] Id., paragraph 28.

The definition of competitive harm is derived from the Commission's enunciated four basic goals for granting the LECs greater pricing flexibility: Encouraging market based prices that reflect cost of service; encouraging efficient investment; encouraging competitive entry; and allowing regulation of noncompetitive markets in the most efficient and least intrusive manner.[3] Thus, avoiding competitive harm by way of allowing access prices to move towards economic costs is seen by the Commission as encouraging market based prices, and encouraging competitive entry means not imposing new endogenous barriers to entry.

However, only the last of these goals — reducing regulation — is under the Commission's direct control. Objectives like moving prices towards economic costs and encouraging efficient investment can be achieved only indirectly and measured only by inference. A regulatory agency is not in a position to precisely determine the relationship between prices and economic costs and is probably not capable to distinguishing "efficient" from "inefficient" investment. Only the actual participant(s) in a functioning market possess the information necessary to demonstrate that the Commission's stated goals are, in fact, realized.

The question posed by the Pricing Flexibility Notice is thus whether both empirical and theoretical support exist for the Commission's first level of proposed pricing flexibility, i.e., additional downward LEC pricing flexibility under price caps without regard to the existence of any competition.

In empirical terms, we will show that, to date, price cap LECs have not reduced prices to the extent permitted by the existing FCC rules. Hundreds of millions of dollars in available downward pricing flexibility remain unused at this time by the price cap LECs. The immediate need for unlimited downward pricing flexibility

[3] Id., paragraph 1.

cannot be discerned from the LECs' pricing behavior.

In economic theory, it is also true that neither the price caps LECs, nor, for that matter, any type of firm, have altruistic incentives to lower prices to economic costs in the absence of a competitive stimulus. Price reductions are always pragmatic in a profit maximizing economy. There simply is no economic basis to believe that any firm enjoying significant barriers to entry and a large installed base of customers would altruistically emulate an effectively competitive market and lower prices. Any access price reductions under either the existing rules or the Commission's proposed modifications will be made only when the LECs perceive a competitive need to do so.

When price cap LECs do make larger downward price reductions, the Commission is correct that the possibility of their creating endogenous barriers to competition must be a consideration. Downward price reductions by firms with monopoly power may respond to actual competition, but they may also be used as predatory signals warning potential entrants against trying to compete — creating an endogenous entry barriers. The relevant literature on industrial organization economics recognizes the possibility that various types of price reductions may be predatory and economically inefficient. As we discuss below, price cap LECs confront a number of incentives, some based upon factors outside their control, to engage in predatory price signalling if they are given unfettered downward pricing flexibility without certain checks.

The economic literature suggests that it will be virtually impossible for the Commission to differentiate such additional downward pricing adjustments by dominant incumbent LECs between price changes that represent welfare-enhancing responses to competition or that involve predatory pricing. The Commission cannot rely on case-by-case investigations to make this type of differentiation. The price cap pricing flexibility rules themselves must be structured as much as possible to provide the LECs with the market-like incentives to engage in only price reductions that improve consumer welfare and to bypass possibly predatory pricing responses to emerging competition.

Although unlimited downward pricing flexibility for the LECs has a certain simple appeal, it is not apparent that the Commission can implement such rule changes without risking competitive harm. Outside interests, like the Commission, cannot clearly differentiate efficient pricing responses from predatory price signalling. Therefore, we suggest three rules for additional LEC downward pricing flexibility.

- First, requiring a modest competitive trigger before permitting the LEC to engage in further downward flexibility outside the current rules does nothing more than recognize market realities, i.e., the absence of economic incentives to engage in altruistic price reductions. Thus, even the first level of additional downward pricing flexibility should depend upon some sort of competitive trigger — albeit one involving a less rigorous competitive showing than either of the other two levels.

- Second, the Commission should recognize that price cap LECs, once confronted with competition, may have stronger incentives than other firms to use predatory pricing as a strategy to limit market entry. The LEC incentives arise both by virtue of the distortions in the current interstate access rules and because the nature of telecommunications reduces the possibly for incumbent LECs to use means other than price-signalling to limit market entry. Additional LEC pricing flexibility should always be accompanied by an ceiling price constraint. That is, the effects of all changes in the actual price indexes for the group of flexibly-priced services should be subtracted immediately and permanently from the upper limit of price band index.

- Third, the rules should be as simple as possible, both the achieve the Commission's goal to reduce regulation and to prevent individual price cap LECs from utilizing an overly complex category structure to engage in additional price discrimination. The ability to invidiously discriminate increases incentives for predatory pricing. Thus, most of the proposed pricing flexibility mechanisms, including all of the proposed "Track 2" services, any alternative pricing plans (APPs) and services that are already subject to geographic pricing flexibility should eventually be contained in a common basket.[4]

This formulation, requiring some competitive trigger for additional downward pricing flexibility and utilizing a ceiling price constraint, may well reflect the forces inherent in a fully competitive market better than some of the potential procedures outlined in the Pricing Flexibility Notice.[5] Overall this approach may require fewer regulations for the Commission to administer and fewer procedures with which price cap LECs must comply.

**Discussion**

Economics teaches that prices in competitive markets move towards economic or marginal costs, but does not suggest that firms altruistically adopt such behavior individually. In a competitive market, the marginal cost towards which the market clearing prices are driven reflects the average marginal cost of all firms in that market.

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[4] See Notice, paragraphs 45-53 and 54-60, respectively.

[5] The Pricing Flexibility Notice invites comments that suggest limits on LECs' downward flexibility to discuss the potential harms that would occur by granting pricing flexibility in the absence of a LEC's "demonstration that no barriers to competition exist." Paragraph 34, emphasis added. This establishes an unrealistically rigid standard even for monopoly incumbent LECs. The analysis that follows should not be read to suggest that pricing flexibility must turn upon a LEC's showing that there are no such barriers.

The individual firm with lower than average costs prospers in such a market, and may be able to lower prices to increase its market share. The firm with higher than average costs must reduce them, accelerate innovation or, perhaps, exit the market.

This dynamic does not operate in a pre-competitive market like the markets for most LEC price capped services. A pre-competitive market is one where most consumers are unable to easily shift demand among market participants and the alternative providers themselves face relatively inelastic supply conditions in many areas. Most of the price cap LECs' access services still exhibit these conditions. Because the market marginal cost is what counts, if there is only one supplier the idea that the single supplier would reduce prices to meet the market level lacks meaning. Profit maximizing firms will not generally reduce prices absent a competitive stimulus, unless they are attempting to use such price reductions to signal potential rivals not to enter the market.

The price cap LECs' pricing behavior has until now demonstrated no more than pre-competitive behavior. The LECs have not used most of the pricing flexibility afforded them by the current Commission rules. Today, the regional Bell companies have populated 132 service sub-baskets subject to service band price indexing, either as a result of a Commission requirement for service sub-banding or to implement optional zone density pricing arrangements.[6] Ameritech has populated the most service sub-baskets (26) while BellSouth has populated the fewest (11). However, the Service Band Index (SBI) for only two of the 132 groups is even below the midpoint of the upper and lower bands.[7] None of the SBI's is close to its lower limit, and many other SBIs are at the upper price constraint.

[6] 1995 Annual Access Tariff Filings of Price Cap Carriers, Memorandum Opinion and Order Suspending Rates DA 95-1631, July 21, 1995, Appendix B, "Summary of Price Cap Indices for Bell Operating Companies."

[7] Both baskets with SBIs below the midpoint of the allowed range involve Ameritech services, but the SBI's are still well above the basket floor.